

## Updates



On Friday, July 31, 2020, the Internal Revenue Service (IRS) issued proposed regulations under Section 1061 of the Internal Revenue Code. Enacted as part of the 2017 Tax Cuts and Jobs Act, Section 1061 imposes a new three-year capital gain holding period applicable to interests in certain investment partnerships for tax years beginning on or after January 1, 2018. In addition to setting forth detailed computational rules for determining the portion of an interest holder's capital gain that is subject to the three-year holding period, the proposed regulations clarify the application of several exceptions from the three-year holding period rule under Section 1061 and close several planning opportunities that existed under the language of the statute.

[As detailed in our 2018 update summarizing the Section 1061 rules](#), Section 1061 provides that certain capital gains attributable to "applicable partnership interests" are taxed at short-term capital gains rates unless the underlying asset is held for more than three years. The three-year holding period requirement applies to

applicable partnership interests transferred to fund managers in connection with the performance of services in an investment trade or business, but excludes:

- Interests attributable to the contribution of capital or interests in partnership capital taxed to the service provider under Section 83 (capital interests).
- Interests issued to employees of an entity that is engaged in a non-investment fund trade or business (such as employees of a manufacturing company operating as a partnership).
- Interests in an investment fund partnership issued to employees of another entity that is engaged in a non-investment fund trade or business (such as employees of a fund portfolio company).
- Interests directly or indirectly owned by a corporation.
- Interests in gains and losses that are attributable to assets that are not held for portfolio investment on behalf of third-party investors.

The proposed regulations also introduce an additional exception for an applicable partnership interest that is purchased from a service provider for fair market value by an unrelated buyer that does not currently and has never provided services to the relevant investment fund business (and is not expected to do so in the future).

The proposed regulations contain technical rules relating to the implementation of these exceptions, but also contain some important limitations:

- Reflecting the guidance previously announced by the IRS in Notice 2018-18, under the proposed regulations an interest held by an S corporation does not qualify for the corporation exception from Section 1061. The proposed regulations also exclude an interest held by a passive foreign investment company (PFIC) for which the applicable taxpayer has made a "qualified electing fund" election to include the PFIC's income and losses on a pass-through basis. Interests in S corporations and such electing PFICs would be treated as applicable partnership interests for purposes of Section 1061. The proposed regulations make these rules effective retroactively to tax years beginning after December 31, 2017, with respect to S corporations, and to tax years beginning after July 31, 2020, with respect to PFICs.
- The exception for portfolio assets that are not held for investment on behalf of third parties would only be applicable to the extent a service provider's allocations of capital gains arising from such assets are commensurate with his or her interest in the partnership's invested capital (i.e., from direct investment by the service provider). Thus, any carried interest held by an investment manager in a family office investment partnership would continue to be subject to Section 1061.
- The proposed regulations would treat a distribution of the partnership's assets to the holder of an applicable partnership interest as a continuation of the applicable partnership interest for purposes of the three-year holding period rule. This provision would curtail a strategy previously employed by some taxpayers to avoid Section 1061 by causing the investment partnership to distribute assets held for less than three years to carried interest partners prior to a sale, and allowing the partners to sell the assets to the buyer directly (rather than receiving an allocation of gain through the partnership that would be recharacterized as short-term capital gain under Section 1061).
- The proposed regulations amend certain holding period rules under Section 1223 to clarify that for partnership interests consisting of both a profits interest and a capital interest, the holding period attributable to the profits interest portion is determined based on the relative fair market value of the profits interest at disposition, rather than upon receipt.
- The proposed regulations clarify that the three-year holding period rule of Section 1061(a) applies only to assets that produce capital gains or losses that are treated as long-term capital gain under paragraphs (3) and (4) of Section 1222. Of primary interest to real estate funds, Section 1231 gains and losses (for example, the sale of real estate held for rental income) are treated as long-term based on the operation of Section 1231, and not by reference to paragraphs (3) and (4) of Section 1222. Of primary interest to funds trading in commodities, Section 1256 (applicable to certain commodity contracts) provides for specific

character treatment and does not calculate gain by reference to Section 1222. Accordingly, the proposed regulations provide that long-term capital gains determined under Section 1231 or Section 1256 are excluded from application of the three-year holding period rule.

- Finally, the preamble to the proposed regulations addresses the use of carried interest "waiver" provisions in investment fund agreements, whereby a fund's carried interest partner may elect to waive its entitlement to allocations of capital gains that would be subject to Section 1061 in exchange for a priority allocation of future long-term gains. The preamble includes a brief statement indicating that the IRS and the U.S. Department of the Treasury believe that such arrangements are potentially abusive and may be subject to challenge under substance-over-form, economic substance, and other anti-abuse principles. The statement in the preamble is presumably purposefully vague and provides no specific guidance as to how these principles would apply to existing waiver arrangements.

The proposed regulations are generally effective for taxable years beginning on or after the date that final regulations are published, except as otherwise noted above.

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